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No. 728

In the Supreme Court of the United States

October Term, 1961

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v.

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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

T. M. AND JOSEPHINE S. EVANS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the Court of Appeals for the Third Circuit in this case.

OPINION BELOW

The opinion of the District Court (R. 149a–160a)[1] is reported at 188 F. Supp. 9. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 9–17) is reported at 295 F. 2d 713.

JURISDICTION

The judgment of the Court of Appeals was entered on November 8, 1961. (Appendix B, *infra*, p. 17.)

[1] Record references are to Appendix B to the brief filed on behalf of the United States in the court below.

By order of Mr. Justice Frankfurter, dated February 5, 1962, the time within which a petition for certiorari might be filed was extended to and including February 16, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the limited rights afforded a borrower under sinking fund and related security provisions of an indenture to redeem taxable bonds on 30 days' notice at a special redemption price establish an "earlier call date" within the meaning of Section 171 of the Internal Revenue Code of 1954, thereby enabling taxpayers who purchase such bonds to write off the difference between their basis and the special redemption price as a deduction from ordinary income in the year of purchase.

STATUTES INVOLVED

Sections 161 and 171 of the Internal Revenue Code of 1954 are set forth in Appendix A, *infra*, pp. 7–8.

STATEMENT

The undisputed facts may be summarized as follows:

In October, 1954, taxpayer[1] purchased $2,000,000 face amount of public utility bonds at a total cost of $2,227,930.96. All or any part of the bonds were redeemable by the issuer at any time on 30 days' notice at a "general" redemption price of a stated amount. Additionally, the issuer could redeem a part of the

[1] Josephine S. Evans is a party to this action only because a joint return was filed. Consequently, as used in this petition, the term "taxpayer" refers only to T. M. Evans.

bond issue, to be drawn by lot, at a lower "special" redemption price to the extent of the cash deposited with the trustee in three funds specified in the indentures: (1) the sinking or improvement fund; (2) the maintenance fund; and (3) the release of property fund. A redemption under those provisions similarly required 30 days' notice. (R. 59a–60a, 150a, 158a–159a.)

In his federal tax return for the year 1954, taxpayer claimed a deduction, under Section 171 of the Internal Revenue Code of 1954, in the amount of $170,500 as amortization of the premium he had paid for the acquisition of the $2,000,000 face amount bonds. The claimed deduction represented the difference between taxpayer's purchase price and the "special" call price at which bonds might be redeemed under the sinking fund and related provisions. Taxpayer amortized the premium over the 30-day period following the purchase of the bonds (i.e., October 1954 to November 1954), on the ground that the rights of redemption were exercisable on 30 days' notice (R. 151a).

Taxpayer instituted this action in the United States District Court for the Western District of Pennsylvania against Dudley, a former District Director of Internal Revenue, seeking a refund of an overpayment for the year 1954 due to an erroneous computation in his return for that year. (R. 8a–13a.) The United States, pursuant to Section 7422(c) of the Internal Revenue Code of 1954, filed a complaint in intervention. (R. 17a–18a.) The government contended (R. 149a) that taxpayer was

not entitled to any bond amortization deduction and, alternatively, if he were entitled to a deduction, it should be limited to the excess of the purchase price over the "general" redemption price rather than, as claimed by taxpayer, the "special" redemption price. The issues raised by taxpayer in his complaint (and in a further counterclaim (R. 19a–29a)) were resolved by final orders of the District Court, and no appeals were taken as to them. (R. 150a.) On the issues raised by the government's complaint in intervention the District Court held for the taxpayer, and the Court of Appeals affirmed. (R. 149a–160a; Appendix B, *infra*, pp. 9–17.) The Government seeks a writ of certiorari only on the limited question of whether the amortization deduction should be based on the "general" or the "special" redemption price.

REASON FOR GRANTING THE WRIT

The decision below allowing taxpayer a bond premium amortization deduction on the basis of the "special" redemption provisions of the bonds is in conflict with the decision of the Court of Appeals for the Second Circuit in *Gourielli's Estate* v. *Commissioner*, 289 F. 2d 69. This Court has granted certiorari in the *Gourielli* case, *sub nom. Hanover Bank* v. *Commissioner* (No. 224).[3] As the issue here is identical to that involved in *Hanover Bank*, the correctness of the decision below will necessarily turn upon the decision of this Court in that case.

[3] Although the *Hanover Bank* case arises under Section 125 of the 1939 Code, while this case is governed by Section 171 of the 1954 Code, the provisions of the two sections relevant to the question presented here are identical.

Indeed, Judge Goodrich, writing for the court below, acknowledged that the decision in this case was contrary to the *Gourielli* decision and that "Certiorari has been granted in the Second Circuit's case and we shall have, in due course, an authoritative answer to our question." (Appendix B, *infra*, p. 15.)

Inasmuch as the *Hanover Bank* case is scheduled for argument during the session beginning February 19, 1962, we suggest that it would be appropriate for the Court to defer action on this petition until the *Hanover Bank* case has been decided and then, as the circumstances warrant, either deny certiorari or grant certiorari and remand the case for reconsideration in the light of the decision in that case.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted or held to await the disposition of the *Hanover Bank* case (No. 224).

Respectfully submitted.

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FEBRUARY 1962.

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 161. ALLOWANCE OF DEDUCTIONS.

In computing taxable income under section 63(a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).

SEC. 171. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond:

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

* * * * * *

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined—

(A) with reference to the amount of the basis (for determining loss on sale or exchange) of such bond,

(B) with reference to the amount payable on maturity, or on earlier call date (but in the case of bonds described in subsection (c)(1)(B) issued after January 22, 1951, and acquired after January 22, 1954, only if such earlier call date is a date more than 3 years after the date of such issue), and

(C) with adjustments proper to reflect unamortized bond premium, with respect to the bond, for the period before the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. In the case of a bond described in subsection (e)(1)(B) issued after January 22, 1951, and acquired after January 22, 1954, which has a call date not more than 3 years after the date of such issue, the amount of bond premium attributable to the taxable year in which the bond is called shall include an amount equal to the excess of the amount of the adjusted basis (for determining loss on sale or exchange) of such bond as of the beginning of the taxable year over the amount received on redemption of the bond or (if greater) the amount payable on maturity.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium prescribed by the Secretary or his delegate.

* * * * *

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 13,559

T. M. EVANS AND JOSEPHINE S. EVANS

v.

ALEXANDER J. DUDLEY, INDIVIDUALLY, AND AS FORMER DISTRICT DIRECTOR OF INTERNAL REVENUE

UNITED STATES OF AMERICA, INTERVENOR, APPELLANT

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA.

Argued September 21, 1961

Before GOODRICH, MCLAUGHLIN and HASTIE, *Circuit Judges.*

OPINION OF THE COURT

(Filed November 8, 1961)

By GOODRICH, *Circuit Judge.*

The United States appeals from a judgment of the District Court for the Western District of Pennsylvania ordering a refund to the taxpayer of money

which he claimed was improperly collected from him. 188 F. Supp. 9 (1960).[1]

In 1954 the taxpayer, in two transactions, bought $2,000,000 worth of public utility bonds at a premium. These bonds had been issued prior to January 22, 1951, and were callable on thirty days' notice at a price lower than the purchase price. Mr. Evans put up $118,000 cash of his own and borrowed the remainder of the purchase price from the Mellon National Bank and Trust Company in Pittsburgh. That the loan was completely bona fide and represented an obligation from borrower to lender is not questioned. After holding the bonds for thirty days Mr. Evans, still in 1954, donated $1,250,000 face amount of the bonds to charities, $700,000 going to Yale University and $550,000 to the T. M. Evans Foundation on the condition that the charities assume the indebtedness on the bonds. No doubt is raised that each of these recipients was a proper subject of a charitable donation. The taxpayer, in his return for 1954, took a deduction under Section 171 of the Internal Revenue Code of 1954 by way of amortization of the premium which he had paid on the acquisition of the bonds. This deduction is squarely within the language of Section 171 of the 1954 Code.[2] He also took a deduction for his contributions to Yale and the T. M. Evans Foundation.

---

[1] The taxpayer, T. M. Evans, and his wife, Josephine S. Evans, filed a joint return and so Mrs. Evans is a party to the record. But the controversy here deals solely with transactions in which only Mr. Evans took part. He is, therefore, referred to as "the taxpayer."

[2] The portions of § 171 applicable to the transactions in question are as follows:

§ 171. *Amortizable bond premium.*

(a) *General rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the

The Government feels very badly that the taxpayer thus secured a double deduction. It suffers even more because the taxpayer, being in the highest tax bracket, really made a profit, tax-wise, out of the combined deductions.[4] Mr. Evans frankly admitted

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amortizable bond premium (determined under subsection (b) on the bond:

(1) *Interests wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

* * * * * *

(b) *Amortizable bond premium.*—

(1) *Amount of bond premium.*—For purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined—

(A) with reference to the amount of the basis (for determining loss on sale or exchange) of such bond,

(B) with reference to the amount payable on maturity or on earlier call date (but in the case of bonds described in subsection (c)(1)(B) issued after January 22, 1951, and acquired after January 22, 1954, only if such earlier call date is a date more than three years after the date of such issue). * * *

* * * * * *

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. * * *

As previously stated, Mr. Evans put up $118,000 of his own money. The amortizable bond deduction amounted to $170,500, resulting in a tax saving of $139,414. The gifts of $1,250,000 face amount bonds in 1954 resulted in an additional deduction of more than $87,000, and a gift of the remainder of the bonds in 1955 increased this figure to more than $100,000. Thus, taxpayer's total tax saving was close to $240,000. As the Government plaintively points out in its brief: "[I]ndeed, it would have been cheaper for the Government to have itself donated double the amount of taxpayer's gift directly to the charities."

that the thing which caused him to set up the transactions the way he did was the possibility of the double deduction and that he had been advised about it through both investment and legal counsel.

It is this motivation of tax avoidance which is the basis of the Government's insistence that Mr. Evans is not entitled to the amortization deduction on his bonds. Great point is made of *Gregory* v. *Helvering*, 293 U.S. 465 (1935), and some of the language in that decision.

It is to be noted, however, that there was no pretense about the transaction by which the taxpayer acquired these securities. As the district court pointed out, he had all the rights and obligations of ownership. If the bonds declined he stood to suffer loss.* Conversely, he was entitled to the benefit of any advance in market value and to the income from the bonds during the time he held them. He had no commitment to sell the bonds or to give them away. Whatever plan he had was only in his mind. Neither Yale University nor the T. M. Evans Foundation could have forced the gift. In other words, here is a man who had become the full owner in a straightforward commercial transaction of a purchase of utility bonds which he was privileged either to keep or to give away. He gave them away. The only basis of attack on the deduction which the plain words of the statute give is the fact that he was motivated by a desire to avoid taxes and got competent advice to accomplish it. If tax avoidance, within the rules, is to take a case out of a deduction provided by statute, we think every legally advised taxpayer is going to find himself in very hot water.

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*This in fact occurred in one of the First Circuit cases which we cite below, *Sherman* v. *Commissioner*, No. 5861, Oct. 5, 1961.

The point in this case is that the purchase of these bonds by the taxpayer was a real and not a feigned transaction.

At the time this case was argued before us the taxpayer could rely upon the Seventh Circuit's decision in *Maxsted Foods, Inc. v. Commissioner*, 287 F. 2d 428 (1961), and the Sixth Circuit case of *Parnell v. United States*, 187 F. Supp. 576 (M.D. Tenn. 1958), *aff'd per curiam*, 272 F. 2d 943 (1959). In the meantime, however, the First Circuit has decided for the taxpayer in three cases, all of which were handled in the same opinion and all of which support the district court result in this case: *See Pittsburgh Steels Co. v. Commissioner*, No. 5786; *Broad Street Trust Co. v. Commissioner*, No. 5795; *Sherman v. Commissioner*, No. 5801, all decided Oct. 5, 1961.

The provision of the 1954 Code contained a limitation on the deduction in the case of bonds issued after January 22, 1951. The Technical Amendments Act of 1958, 72 Stat. 1610, made a further modification. As Judge Aldrich says in concluding the First Circuit opinion: "Granting the government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the court's."

The 1954 Code added the provision that the premium on callable bonds may be amortized to the nearest call date only if that date is more than three years from the date of the original issue of the bonds. See note 2 *supra*. However, this provision did not apply to taxpayer's bonds since they were issued before January 22, 1951.

The 1958 amendment in substance provided that the premium on any taxable bond acquired after December 31, 1957, may not be amortized to any date earlier than the maturity date unless a similar deduction results from amortization to an earlier call date.

This leaves us with the further difficult point, however, of whether the taxpayer is to have amortization on the basis of the "general" call price of the bonds or the lower "special" call price, which results in a larger deduction. As we understand it, a general call is one which a corporation employs when it finds that the current rate of interest on bonds is substantially less than what it is paying on an outstanding issue. If there is a provision in the bond permitting it to be called, the debtor may call it and refinance his obligations at a lower interest rate. Of course, the general call price must be high enough to compensate the lender for the loss of his now-profitable investment. On the other hand, a special call is one by which, subject to the terms of the original contract, bonds may be called and paid for out of special funds set up by the terms of the indenture and to which the debtor is obligated to make periodic payments. A typical example would be a sinking fund to which the debtor each year makes a stipulated payment. A purchaser, when he buys bonds on the market, does not know whether his bonds will be called at all before maturity or, if they are, whether it will be at the special or the general call price.

The district court in this case allowed the taxpayer to amortize the difference between the premium and the special call price, which gave him a larger deduction than if he had been allowed only the general call price. This result has the support of the Sixth Circuit in *Harwell v. United States*, 272 F. 2d 943 (1959), *affirming per curiam* 187 F. Supp. 576 (M.D. Tenn. 1958). It is contrary, however, to the Second Circuit's decision in *Estate of Gowrielli v. Commissioner*, 289 F. 2d 69, *cert. granted*, 30 U.S.L. WEEK 3103 (U.S. Oct. 9, 1961) (No. 224), in which Judge

Friendly, in his always thorough and scholarly discussion, comes to a conclusion affirming the Government's insistence that the general call price is the measure of the deduction. The difference between the Sixth and Second Circuits is not one which will shake the foundation of the United States Treasury. Certiorari has been granted in the Second Circuit's case and we shall have, in due course, an authoritative answer to our question. In the meantime, it is the job of a Court of Appeals to decide the cases before it as best it can with the hope that the best it can is good enough.

The statute itself is certainly not clear. It leaves the matter completely in the air, providing only that the bond premium "* * * shall be determined * * * with reference to the amount of the basis * * * [and] with reference to the amount payable on maturity or on earlier call date * * *." Since 1953 the Service has ruled both ways on the question. See Letter Ruling of Oct. 16, 1953 (allowing special price); Rev. Rul. 56-398, 1956-2 CUM. BULL. 984 (with minor exceptions, limiting deduction to general price).

We think, first of all, that this question should be settled by a general rule applicable to the cases as and when they come up. We think it would be hard on the taxpayer, as well as a difficult problem of administration, to go into the question of whether in any particular case there is a probability of a call of the bonds involved, whether the funds out of which a special call is to be made are sufficient, whether the price of the bonds has dropped low enough so the debtor is buying its own bonds on the market and retiring them in that manner, and so on and so on. We think both Government and taxpayer will be better off with a general rule.

With complete deference to the Second Circuit opinion, we are going to take the other view and uphold the district court in its allowance of the deduction based on the special call price. We have testimony from the plaintiff's expert that in the three months prior to the hearing of this case there were seven special calls of public utility bonds and no general calls. There was also testimony, not necessarily convincing in reaching a result, that if there were any calls to be made during 1954 and 1955 they would have been made at the special call price. The taxpayer's expert also testified that the special call price is usually the price at which the offering is first made to the public. An examination of Standard and Poor's *Bond Guide* for 1954 and 1960 shows that in those years special calls were numerically more frequent than general calls and that a substantial dollar amount of bonds was called specially in both years. It seems to us that these factors are significant in supporting a conclusion that an allowance based on the special price is a fair one and one which the taxpayer would expect to have happen.

We are satisfied, therefore, with the special call price sustained by the district court until we are told by the Supreme Court that the other rule is to prevail.

The judgment of the district court will be affirmed.

A True Copy:
Teste:

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Clerk of the United States Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 13,559

T. M. EVANS AND JOSEPHINE S. EVANS

vs.

ALEXANDER J. DUDLEY, INDIVIDUALLY AND AS FORMER DISTRICT DIRECTOR OF INTERNAL REVENUE

UNITED STATES OF AMERICA, INTERVENOR, APPELLANT

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

Present: GOODRICH, McLAUGHLIN and HASTIE, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Western District of Pennsylvania and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this case be, and the same is hereby affirmed.

Attest:

IDA O. CRESKOFF, *Clerk.*

NOVEMBER 8, 1961.

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, in the case of bonds having alternate call prices, the amount of the amortizable bond premium is to be computed only with reference to the price at which such bonds are callable at the option of the borrower or, as was held by the courts below, with reference to lower prices at which the bonds must be called under certain conditions?

ARGUMENT

The decision in *Estate of A. Gourielli v. Commissioner*, 289 F. 2d 69 (C.C.A. 2d), which was argued in this Court on February 27, 1962, *sub nom. Hanover Bank v. Commissioner* (No. 224), turns upon the Second Circuit's finding of the unlikelihood of the bonds there involved being redeemed by a "special" call during the year 1953. The opinion by Judge Friendly makes this clear:

> "... We likewise hold the additional deductions claimed by the taxpayers may not be taken *on the facts here* ..." (289 F.2d 69, 70) (Emphasis supplied)

> "... Whether a bondholder might be entitled to use a 'special' redemption price for computing bond premium if there were circumstances indicating the likelihood of a substantial call at that price when he first elected a method of amortization, or whether, having elected to amortize to a 'general' call price, he might be permitted a further deduction for amortization if facts indicating the likelihood of such a call at the 'special' price later appeared, we do not find it necessary here to decide." (289 F. 2d 69, 74-75)

This basis of decision is inconsistent with the adoption of a general rule not dependent on the probability or improbability that particular issues of bonds will be redeemed during a particular year. If there is to be a general rule, as Government and taxpayer both agree should be the case (Respondent's brief in *Hanover Bank v. Commissioner* (No. 224) at page 16), that rule must permit amortization to the special call price. This is clear

from the opinion in the Third Circuit in the instant case. Judge Goodrich, having first decided that "both Government and taxpayer will be better off with a general rule" (295 F. 2d 713, 716), rightly concludes that an allowance based on the special call price is the fair and proper rule, and the only rule that can be applied consistently. He said:

> "With complete deference to the Second Circuit opinion, we are going to take the other view and uphold the district court in its allowance of the deduction based on the special call price. We have testimony from the plaintiff's expert that in the three months prior to the hearing of this case there were seven special calls of public utility bonds and no general calls. There was also testimony, not necessarily convincing in reaching a result, that if there were any calls to be made during 1954 and 1955 they would have been made at the special call price. The taxpayer's expert also testified that the special call price is usually the price at which the offering is first made to the public. An examination of Standard and Poor's Bond Guide for 1954 and 1960 shows that in those years special calls were numerically more frequent than general calls and that a substantial dollar amount of bonds was called specially in both years. It seems to us that these factors are significant in supporting a conclusion that an allowance based on the special price is a fair one and one which the taxpayer would expect to have happen." (295 F. 2d 713, 716)

CONCLUSION

The Petition for a Writ of Certiorari should be denied if the Court concludes in the *Hanover Bank* case (No. 224) that the right to amortize to the "special" call price is not to be determined case by case according to the likelihood of redemption by special call. Even if the decision in *Hanover Bank* requires an affirmance on the facts there, the Petition should also be denied, in view of the findings in the instant case by the District Court and the affirmance of those findings by the Third Circuit.

Respectfully submitted.

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